

**§199 Domestic Production Deduction Update  
Construction taxpayers  
Summary**

There were a number of significant changes to these rules during the most recent year and given the increased percentage applicable for 2007, this is a good time to revisit the rules. Enacted as part of the American Jobs Creation Act of 2004, these rules are overly complex and lengthy. The focus of this summary is in connection with construction activities but also apply to other traditional manufacturing activities and other specified fields of endeavor.

The formula is as follows:

	<b>Lesser of...</b>		
% x	QPAI or Taxable inc.	= §199 deduction	Limited to 50% of W-2 wages

The appropriate percentage is:

- 3% in 2005–2006;
- 6% in 2007–2009; and,
- 9% in 2010 and thereafter

Definitions:

- Qualified production activities income (QPAI) – is the taxpayer’s domestic production gross receipts (DPGR) for the year less costs of goods sold and other expenses (direct and indirect) properly allocable to DPGR;
- Domestic production gross receipts (DPGR) – is the entity's gross receipts from the lease, rental, license, sale, exchange, or other disposition of QPP that was MPGE in whole or in significant part within the U.S. Gross receipts from a related party rental, lease, or license are excluded. For this purpose, a related party is a commonly controlled business, whether incorporated or unincorporated, an affiliated service group or employee leasing agreement, and similar arrangements. GOZA clarifies that in applying the definition of DPGR with respect to construction activities, only gross receipts derived from the construction of real property by a taxpayer engaged in the active conduct of a construction trade or business qualify. In other words, the taxpayer must be in the construction trade or business in the ordinary course of such trade or business and not in an investor capacity;
- Taxable income for the tax year for purposes of the formula is determined without regard to the §199 deduction;
- MPGE – refers to activities involving manufacturing, producing, growing, extracting, installing, building, developing, improving, and creating QPP;
- QPP – is tangible personal property, computer software, and sound recordings. Tangible personal property is any tangible property other than land, buildings, including items that are structural components of a building. Production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs that are contained in or attached to a building are tangible property for purposes of the deduction.

- W-2 wages – TIPRA amended the definition of wages in two significant ways. First, the term W-2 wages includes only so-called paragraph (e)(1) wages that are properly allocable to DPGR. A taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR using any reasonable method that is satisfactory to the IRS based on all the facts and circumstances. Two safe harbor methods are also provided discussed later. Second, partners or shareholders of pass-through entities now are treated as having W-2 wages in an amount equal to their allocable share of W-2 wages from the pass-through entity, and there is no longer a rule limiting allocated W-2 wages from a pass-through entity to the minimum amount of wages necessary to allow a deduction for QPAI generated by the pass-through entity. Paragraph (e)(1) wages basically is wages plus elective deferrals plus designated Roth contributions.

The deduction is allowed for both regular tax and AMT, including adjusted current earnings.

### **Allocation of costs**

Recall that the definition of QPAI is the taxpayer's DPGR for the year less costs of goods sold and other expenses (direct and indirect) properly allocable to DPG. Thus, the next step is to allocate the appropriate COGS and expenses/costs against DPGR to determine QPAI.

- When allocating COGS, taxpayers must specifically identify and trace costs from their books and records to DPGR. Taxpayers without any non-DPGR will simply subtract 100% of COGS. Taxpayers with both DPGR and non-DPGR that cannot specifically identify costs without undue burden can use any reasonable method to allocate costs. Reasonable allocation methods include methods based on gross receipts, number of units sold, number of units produced, or total production costs. Consistency is a must. If a particular method is used to allocate gross receipts between DPGR and non-DPGR, use of a different method to allocate COGS would likely held unreasonable unless the method is clearly more accurate for COGS allocation purposes.

- Other deductions and costs must be allocated under one of three methods:

**§861 Method** - Under the §861 method, direct and indirect costs are specifically allocated and apportioned between DPGR and non-DPGR sources. Very complex and burdensome rules are involved. While the resulting QPAI is probably more accurate than under the other two methods, the offsetting costs and complexity of computing QPAI and the recordkeeping requirements for using this method likely will exceed any benefit derived by using this method.

**Small Business Simplified Overall Method** - Small taxpayers can use this business method to apportion not only COGS but also for other deductions based on the ratio of DPGR to non-DPGR revenue sources. To qualify for this method, the taxpayer must have average annual gross receipts of \$5 million. Taxpayers with average annual gross receipts of \$10 million or less, and who are allowed to use the cash method under Rev. Proc. 2002-28, also qualify for the small business simplified overall method.

**Simplified Deduction Method** - Taxpayers with average annual gross receipts of \$100 million or less, or total assets of \$10 million or less at the end of the tax year, can use this method. The simplified deduction method works mechanically the same as the small business simplified overall method except that taxpayers cannot use the

simplified deduction method for COGS. All that the simplified deduction method does is extend the availability of the small business simplified overall method to allocate other deductions to taxpayers with average annual gross between \$5 million and \$100 million with the caveat that COGS must be specifically identified and traced to DPGR. For partners and S corporation shareholders, the ability to use the simplified deduction method is determined at the individual and not the entity level.

**Taxpayers can elect to use any of these methods at any time for any year and switching methodology is not an accounting method change.**

**Example** - Custom Builder, Inc., builds small custom homes in the U.S. In addition, Custom sells personal property (appliances) which accounts for 10% of its gross receipts. Custom must allocate its income and deductions between its DPGR (homebuilding) and non-DPGR (sale of appliances). Custom's gross receipts for the year are less than \$5 million so it qualifies to use the small business method. Custom's books of account reflect the following data for the year:

	<u>Homebuilding</u>	<u>Personal prop.</u>	<u>Total</u>
Gross receipts	\$3,500,000	\$380,000	\$3,880,000
Cost of goods sold	2,100,000	190,000	2,290,000
Indirect costs	1,200,000	100,000	1,300,000

Under the small business simplified overall method, Custom would allocate \$2,065,722 of its COGS to its DPGR activity  $[(\$3,500,000 \div \$3,880,000) \times \$2,290,000]$ ; and would allocate \$1,172,680 of its indirect costs to its DPGR activity  $[(\$3,500,000 \div \$3,880,000) \times 1,300,000]$ . Custom's QPAI would be \$261,598  $(\$3,500,000 - \$2,065,722 - \$1,172,680)$ . Had Custom used the simplified deduction method (specifically allocating COGS to DPGR), its QPAI would have been \$227,320  $(\$3,500,000 - \$2,100,000 - 1,172,680)$ . By using the small business simplified overall method, Custom has more QPAI, and thus a larger domestic production activities deduction.

**Construction activities**

DPGR from the construction of real property performed in the U.S. includes proceeds from the sale or other disposition of real property constructed by the entity and includes residential and commercial buildings and infrastructure such as roads, power lines, water systems, and sewers. The taxpayer must be active in the construction business [North American Industry Classification System (NAICS) code 23] and this must be the taxpayer's ordinary trade or business.

- Property produced by a taxpayer that is not real property in the hands of the taxpayer (i.e., bricks, nails, window frames), but which is ultimately incorporated into real property by another taxpayer, is not treated as real property to the producing taxpayer;
- To qualify, the taxpayer must be in the construction business on a regular and ongoing basis for its construction activity to qualify. It does not need to be the only business or even the primary business of the taxpayer but must be a regular and ongoing business;
- A taxpayer will be deemed to be in the regular and ongoing trade or business of construction if the taxpayer derives gross receipts from an unrelated third party by selling or exchanging the constructed real property within 60 months from the date of completion (i.e., the date the certificate of occupancy is issued). If the taxpayer just started the construction business, it will be deemed to be engaged in it on a regular and

ongoing basis if the taxpayer reasonably expects that it will continue in the construction business on a regular and ongoing basis;

- To construct real property means to erect or substantially renovate the property. Land improvements and painting qualify as construction only if connected with other activities that constitute the erection or substantial renovation of real property. A substantial renovation increases the value of the property, prolongs the property's useful life, or adapts the property to a new or different use. Landscaping and other land activities not capitalizable to land and painting constitute construction only if they are performed with other activities that involve building or substantial renovation of real estate. Grading, demolition, clearing, excavating, and other activities that transform land are construction activities only if they are done in connection with the building or substantial renovation of real estate. The taxpayer must make a reasonable inquiry or a reasonable determination as to whether the activity actually relates to building or substantial renovation of real estate;
- If less than 5% of the gross receipts received by a taxpayer from a construction project are derived from activities other than the construction of real property (e.g. from the sale of tangible personal property or land), total gross receipts derived by the taxpayer from the project can be treated as DPGR from construction. A similar de minimis rule treats all gross receipts as non-DPGR if less than 5% of gross receipts are DPGR.

#### **Sale of land and use of the safe harbor**

Gross receipts from the sale or other disposition of land do not qualify as DPGR from construction. Since the enactment of these rules, construction industry groups have been urging Congress, Treasury, and anybody else who will listen, to treat receipts allocable to land as DPGR in cases where a taxpayer has engaged in construction activities on that land (thus eliminating any need to allocate receipts from transactions involving the land and the real property constructed on the land) between DPGR and non-DPGR sources. As everybody has rejected this contention, gross receipts must somehow be allocated between construction activities and the sale of land. Under the safe harbor method, you determine DPGR on the sale by reducing the sale proceeds by the cost of the land, any costs capitalized as part of the land (i.e., zoning fees, planning costs, entitlement), and a percentage of the land cost based on the number of months between the land acquisition and the date of sale. The percentage of land cost is based on how long the property has been held:

- 5% if the land has been held 60 months or less;
- 10% if the land has been held more than 60 months, but no more than 120 months;
- 15% if the land has been held for more than 120 months, but no more than 180 months; and,
- If the land has been held more than 180 months, it is not eligible for the land safe harbor.

**Land safe harbor example** - XYZ Builders, who is engaged in the trade or business of construction under NAICS code 23 on a regular and ongoing basis, constructs housing. On June 1, 2006, XYZ pays \$50,000,000 and acquires 1,000 acres of land that XYZ will develop as a new housing development over a 7-year period. In November 2006, after the expenditure of \$10,000,000 for zoning and planning costs, XYZ receives permits to begin construction. On January 21, 2011, the first house is sold for \$300,000. Construction costs for each house are \$170,000. Common improvements consisting of streets, sidewalks, sewer lines, playgrounds, clubhouses, tennis courts, and swimming pools that XYZ is contractually obligated or required by law to provide cost \$25,000 per lot. Indirect costs per lot are \$120,000. XYZ calculates the DPGR for the house sold by taking his gross receipts and

reducing the gross receipts the cost of the land, other costs capitalized as part of the land, any common area costs, and by a percentage of the land cost based on how long XYZ held the land prior to sale. Based on acquisition date of June 1, 2006, for each house sold prior to June 1, 2011, the percentage reduction for XYZ is 5%.

Land cost	\$50,000,000
Zoning, planning, entitlement	<u>10,000,000</u>
Total land costs	60,000,000
# of homes to be built	<u>1,000</u>
Land cost per home	\$60,000
Holding period on sale	<5 years
DPGR reduction (5% x \$60,000)	\$3,000

Pursuant to the land safe harbor, XYZ calculates DPGR and QPAI for the home sold as follows:

Gross proceeds on sale of home	\$300,000
Land cost	(60,000)
DPGR reduction	<u>(3,000)</u>
DPGR	237,000
Construction costs	(170,000)
Common area costs	(25,000)
Indirect costs	<u>(120,000)</u>
QPAI	\$ 75,000

For each house sold on the land between June 2, 2011 and June 1, 2016, the percentage reduction for XYZ is 10% because XYZ has held the land for more than 60 months but not more than 120 months from the date of acquisition.

**More than one taxpayer working on the same construction project**

A taxpayer engaged in construction activities may qualify for the deduction, even if it does not have the benefits and burdens of ownership of the property being constructed. Therefore, more than one taxpayer may be regarded as constructing real property when working on the same construction project. For example, a general contractor and a subcontractor may both be engaged in construction activities when installing a roof on a new building. Each taxpayer's benefit will be a percentage of its profit on its work to install the roof.

**Example** - ABC, Inc. bought a building in the U.S. ABC hired Western Contractors, LLC, (a general contractor in the trade or business of commercial construction; NAICS 236220) to oversee a substantial renovation of the building. Western hired Drip Plumbing (a plumbing, heating, and air conditioning subcontractor; NAICS code 238220) to install a new air conditioning system in the building as part of the renovation. The amounts that Western receives from ABC, and amounts that Drip Plumbing receives from Western, qualify as DPGR. If ABC later sells the building, the proceeds it receives will not qualify as DPGR because ABC did not engage in a construction activity. However, if ABC was in the construction business and had acted as its own general contractor when renovating the building, its proceeds from the sale of the building would qualify as DPGR.

**Determining W-2 wages – in general**

The domestic production activities deduction is limited to 50% of the W-2 wages paid by the taxpayer during the year. For tax years beginning after May 17, 2006, the Tax Increase

Prevention and Reconciliation Act of 2005 limits W-2 wages to amounts properly allocable to DPGR and also repeals the complicated W-2 wage minimum allocation of wages to pass-through entities.

- W-2 wages for Section 199 purposes include wages subject to income tax withholding, wages that are employee elective deferrals, and employee designated Roth contributions. The W-2 wages must actually be reported on Form W-2 filed with the Social Security Administration no later than 60 days after the extended due date for filing the forms they are to count for purposes of the §199 deduction. If corrected W-2s are filed after the 60th day after the extended due date, any increase in W-2 wages is disregarded in computing the domestic production activities deduction, while any decrease in W-2 wages will reduce the 50% of wages limitation for purposes of computing the domestic production activities deduction;
- Taxpayers can count wages paid to employees or former employees, which include common law employees of the taxpayer. The taxpayer may take into account any wages paid by another entity and reported by the other entity on W-2's with the other entity listed as the employer provided that the wages were paid to employees of the taxpayer claiming the §199 deduction for employment with the that taxpayer. However, taxpayers cannot count wages paid as an agent of another entity to persons who are not employees of the taxpayer;
- Guaranteed payments paid to partners are not W-2 wages;
- Taxpayers have three options for computing the W-2 wages

**Unmodified Box Method.** W-2 wages are the wages computed by taking the lesser of Box 1 or Box 5 (Medicare wages).

**Modified Box 1 Method.** Under this method, start with the total of Box 1 wages, then subtract any amounts in Box 1 that are not wages for income tax withholding purposes and amounts included in Box 1 of Forms W-2 that are treated as wages under IRC Sec. 3402(o) , such as supplemental unemployment compensation benefits. Then add to this amounts reported in Box 12 of Form W-2 that are coded D, E, F, G, or S.

**Tracking Wages Method.** This is the most complex method, since it requires the taxpayer to track total wages subject to federal income tax withholding and then make appropriate modifications. The modifications include adjustments for supplemental unemployment compensation and amounts reported in Box 12 of Form W-2 that are coded D, E, F, G, or S.

- Allocation of wages – under Reg. § 1.199-2T(e), for taxable years beginning after May 17, 2006, the term “W-2 wages” includes only amounts described in Reg. § 1.199-2(e)(1) that are properly allocable to DPGR. A taxpayer may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances. Treasury also has provided two safe harbor methods which may be used to determine the paragraph (e)(2) wages allocable to DPGR

**Safe Harbor #1** – a taxpayer using either the §861 method of cost allocation or the simplified deduction method may determine the amount of paragraph (e)(1) wages that is properly allocable to DPGR using this formula:

$$(e)(1) \text{ wages} \quad \times \quad \frac{\text{Wage expense included in the QPAI calculation}}{\text{Wage expense used in calculation taxable income}}$$

Taxpayers using this method must use the same expense allocation and apportionment methods that they use to determine QPAI to allocate and apportion wage expense. The term “wage expense” means wages (compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the taxpayer’s method of accounting. Also, for purposes of these rules, a taxpayer may determine its wage expense included in cost of goods sold (CGS) “using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, such as using the amount of direct labor included in CGS or using § 263A labor costs (as defined in Reg. § 1.263A-1(h)(4)(ii)) included in CGS.

**Safe Harbor #2.** – this safe harbor applies to taxpayers that use the small business simplified overall method to allocate costs. Under this safe harbor, the amount of paragraph (e)(1) wages properly allocable to DPGR is equal to the same proportion that the amount of DPGR bears to the taxpayer’s total gross receipts. Thus if 80% of the taxpayer’s gross receipts consisted of DPGR, 80% of the paragraph (e)(1) wages would be allocated to DPGR.

**Example** – Assume that the taxpayer qualifies for the §199 deduction. A review of the 2007 company tax reflects the following:

Sales	\$6,000
Purchases	1,600
Wages	<u>800</u>
COGS	<u>2,400</u>
Business expenses	920
Wages	1,000
Interest expense	<u>300</u>
Total deductions	<u>2,220</u>
Taxable income	<u>\$1,380</u>

Gross sales consists of DPGR (\$3,000) and non-DPGR (\$3,000). Directly allocable COGS is \$600 which includes \$200 in wages. Paragraph (e)(1) wages of the taxpayer are \$3,000.

	<b>Simplified deduction method</b>	<b>SB simplified overall method</b>
<b>1st step is to calculate QPAI</b>		
DPGR	3,000	3,000
COGS for DPGR	(600)	(1,200)
Deductions	<u>(1,110)</u>	<u>(1,110)</u>
QPAI	<u>1,290</u>	<u>690</u>

<b>2nd step is to calculate the wage limitation</b>		
Wages in QPAI	700	900

Safe harbor #1	1,167	1,500
DPGR wages	1,167	1,500
50% deduction limit	584	750

**3rd step is to calculate the \$199 deduction**

Preliminary deduction	77	41
50% wage limitation	584	750
Allowable deduction	77	41

DPGR / total gross receipts x \$2,400 and \$2,220.  
 \$200 + (1,000 x DPGR / total gross receipts).  
 (800+1,000) x DPGR / total gross receipts).  
 \$3,000 x (700 / 1,800)  
 \$3000 x DPGR / total gross receipts  
 Maximize the limit to maximize the deduction.

**Partnership and S corporation entities**

The domestic production activities deduction generally is determined at the partner or S shareholder level. As a result, each partner or S shareholder computes its deduction separately by aggregating from all sources within and outside the pass-through entity. The domestic production activities deduction has no effect on a partner or S shareholder's basis in interest.

- Each partner or shareholder must take into account that person's allocable share of DPGR, cost of goods sold, and other expenses or deductions allocable to the DPGR. This allocation applies even if the partner's or shareholder's share of COGS and other deductions and losses exceeds DPGR.
- Taxpayer deductions are taken into account in computing a partner's or shareholder's domestic production activities deduction only to the extent the partner's or shareholder's distributive share of those deductions is not disallowed under the at-risk rules, passive activity loss rules, the basis limitation rules, or any other provision of the Code. If part of the distributive share of the losses or deductions is allowed for the year, a proportionate share of those allowable losses or deductions that are allocated to the taxpayer's qualified production activities is taken into account in computing the domestic production activities deduction for the year. If any of the disallowed amounts are allowed in a later year, the partner or shareholder takes into account a proportionate share of those losses or deductions in computing QPAI for that later year.
- The requirement to allocate a minimum amount of wages has been repealed. Instead, you simply will allocate the amount of paragraph (e)(1) wages among the partners or shareholder in the same manner as you allocate wage expense among the partners or shareholder. The partner or shareholder will then add its share of the paragraph (e)(1) wages to other (e)(1) wage from other sources.

**Example** – Bob and Al each own 50% of Bobal Partners, a calendar year taxpayer that engages in activities that generate DPGR and non-DPGR. Bob and Al share taxpayer items equally. During 2007, Bobal has total gross receipts of \$2,000 (\$1,000 of which is DPGR), COGS of \$800 (including \$400 of W-2 wages), and deductions of \$800. Bobal uses the small business simplified overall method to allocate costs. With respect to Al, assume that

he has taxable income personally of \$100,000. The §199 disclosure and deduction for Al, is computed as follows:

**Tax return data**

	<b>Total</b>	<b>Al</b>	<b>Bob</b>
Gross receipts	2,000		
COGS - wages	(400)		
COGS - purchases	(400)		
ODED	(800)		
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NS income	400	200	200
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**Step 1 – calculate QPAI**

	<b>Total</b>	<b>DPGR</b>	<b>Al</b>	<b>Bob</b>
Gross receipts	2,000	1,000	500	500
COGS	(800)	(400)	(200)	(200)
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Gross profit	1,200	600	300	300
Expenses	800	(400)	(200)	(200)
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QPAI	N/A	200	100	100
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**Step 2 – calculate wage limit**

Share of wages	400	200	200
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**Schedule K & K-1 disclosure is...**

Schedule K - line 13d

Type of deduction – DPGR

QPAI entity-wide – \$200

W-2 wages entity-wide – \$400

Schedule K-1 for Al – line 13

Code T – \$100 [This is Al's share of QPAI]

Code U – \$100 [This is Al's share of wages]

Al would then combine his share of QPAI and share of wages with other QPAI and wages coming from other sources to determine the §199 deduction at the individual level. Assuming that Al has no other QPAI or wages from other sources, his §199 deduction would be computed as follows.

**Step 3 – compute the §199 deduction as to Al**

**Lesser of...**

$$6\% \times \begin{matrix} \$100 \\ \text{or} \\ \$100,000 \end{matrix} = \$6 \begin{matrix} \text{Preliminary} \\ \text{deduction} \end{matrix} \quad \begin{matrix} \text{Limited to 50\%} \\ \text{of W-2 wages} \\ \$100 \end{matrix}$$

That's it. No question that this may be a lot of work for small taxpayers or that the law is more complex than it need be. And this summary is just the tip of the iceberg—there's so much more to it.